A CRITICISM OF THE WAR REVENUE ACT OF 1917

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The purpose of any tax legislation should be to get the maximum amount of revenue with the minimum disturbance to business. In considering any taxation scheme we must have constantly in mind that there are at least two classes of taxpayers which are usually taxed, namely, individuals and corporations. A tax upon a corporation, so far as a corporation can be taxed at all, is a tax upon the stockholders who own the undistributed shares in the property of the corporation. Therefore, a tax imposed upon a corporate body if excessive as compared with taxes upon business transacted in other forms or upon individuals not engaged in business, necessarily constitutes a discrimination so far as the incidence of the tax is concerned against a certain class of individuals.

Originally, all taxation was based upon the theory that the owner of the property taxed received certain benefits from the government imposing the tax. In other words, it was a tax upon benefits received in connection with the privilege of living in a civilized community. From time to time, however, there has been a growing tendency to depart from such forms of taxation based upon benefits derived from the government and to substitute therefor a tax upon ability to pay. This has been the result of a growing tendency to establish a doctrine that those best able to pay should contribute more liberally to the public burden.

It is manifest that an *ad valorem* tax upon property must necessarily be based upon the theory of benefits received and without regard to ability to pay with the possible exception that persons owning property may be presumed to have some ability to pay taxes, although we all know that certain classes of property may in some cases constitute a liability to the owner instead of an asset. Net income taxes, on the other hand, are based almost entirely upon ability to pay with very little regard to the benefits received, with the possible exception that any person deriving a net income and living in civilized society must be presumed to have received some

benefit from the government in the protection of his property from which the income is derived or received. Thus there has gradually grown up in the United States and elsewhere a tendency to impose net income taxes instead of direct taxes upon property.

An investigation of the subject shows that net income taxes have been very generally imposed in the following European countries: Austria, Belgium, Denmark, Greece, Germany, Holland, Luxemburg, Finland, France, Norway, Sweden, Switzerland and Italy; also in the Cape of Good Hope, Hawaii, India, Japan, New Zealand and Australia as well as in the United States. Not only have net income taxes probably become a permanent means of raising revenue in the United States by the federal government, but they are gradually being adopted by many of the states. For example, the state of Wisconsin for a number of years has had an income tax upon both individuals and corporations. This tax is not in lieu of any tax upon personal property, but the individual or corporation subject to the income tax is permitted to deduct from the income tax the amount of any tax paid upon personal property. The state of New York, on the other hand, has adopted an income tax upon manufacturing and mercantile corporations, which tax is in lieu of any tax upon corporate franchises or personal property of such corporations. A number of the other states have imposed income taxes as a basis of determining the amount of tax to be paid as a privilege of doing business in such states in corporate form.

The income tax in theory is probably the most equitable method of taxation because it is not imposed unless the taxpayer has secured a net income during the year and therefore should have the necessary funds with which to pay the tax, the individual whose net income is nil not being required to pay any tax for the benefits he may have received from the government.

While the theory of this tax is most equitable, its application in many cases under certain income tax laws has brought about the grossest inequality. If the taxation system of any jurisdiction is inequitable fundamentally, the imposition of an income tax in addition to all other taxes will not remove the inequalities existing prior to the imposition of the income tax. For example, a number of the states have been imposing upon corporations taxes called franchise taxes and said to be upon the privilege of doing business in a corporate capacity and being in addition to all other taxes upon the property

paid by individuals not doing business in corporate form. A franchise tax upon a corporation in addition to all other taxes upon the property is a discrimination against individuals holding corporate securities and in favor of individuals whose property does not consist of corporate securities. There would appear to be no sound reason for imposing upon corporations by any jurisdiction a tax upon the corporate franchise in addition to taxes upon the property of the corporation. If the property is fully taxed the corporation has paid a tax upon its franchise which has been reflected in the value of the property.

The method of doing business in corporate form has become a necessity and there would appear to be no reason for penalizing an efficient instrument of business. It necessarily follows that, if it be economically unsound to tax corporations upon their franchises in addition to a tax upon their property, the imposition of the franchise tax measured by net income does not in any way correct the wrong principle and such income taxes are not income taxes as those terms are generally understood, but, on the other hand, constitute a tax upon corporate franchises which under all conditions is economically unsound even though measured by net income. Therefore, those states which have imposed a franchise tax measured by net income have in no way progressed, so far as taxation is concerned, but have simply ascertained a convenient means of measuring an inequitable and unjust tax.

If it be wrong for the states to impose a tax upon the privilege of being a corporation or for transacting business in a corporate capacity it is equally wrong for the federal government to impose such taxes. It therefore seems to follow that the capital stock tax imposed by the federal government upon corporations, which is a franchise tax and is not imposed upon partnerships and individuals in competition with corporations, is inequitable and unjust and should not have been enacted. It is no answer to the argument to say that the federal government needed the revenue, because the amount of revenue which can be raised by any jurisdiction depends upon the wealth of the community imposing the tax and within certain reasonable limits the rate under a just tax law can be made sufficiently high to secure all possible revenue.

It has been the history of taxation throughout the states that the states are unable to impose, administer and collect an *ad valorem*

tax upon personal property that absorbed too great an amount of the income from such source. Therefore, the progressive states are fast departing from the imposition of any *ad valorem* tax upon personal property and are substituting therefor either a classified personal property tax at a reasonable rate fixed by the legislature or an income tax measured by the amount of net income. Those states which have made the income tax a tax in lieu of some other tax which could not be collected with full justice to the taxpayers at large have undoubtedly taken an important step in the right direction, while those states that have simply imposed the income tax in addition to all other taxes have in no way removed any of the inequalities which existed prior to the enactment of the income tax, and the only virtue in the income tax in such cases is the amount of additional revenue which has been raised as a result of the tax, and additional revenue is not always a virtue.

There would be no difficulty in the imposition of the income tax if all individuals did business in the same way so that the amount of the tax would be the same in all similar cases and the tax equally distributed over all individuals enjoying a net income. Business is transacted in this country by individuals as such and by corporations. Corporations are nothing more or less than an aggregation of individuals. Therefore discrimination against corporations is a discrimination against the individuals interested in the business transacted in such form. It may be possible to impose a tax either upon the corporation or upon the stockholders, but it is not possible to impose the same tax upon both the corporation and the stockholders without imposing two taxes upon the same individuals. If other individuals, that is, those who are not transacting business in corporate form, are taxed only once it of course is an unwarranted and unjust discrimination to tax the individuals who are transacting business in corporate form twice. Great difficulty has been experienced in imposing an income tax upon corporations without doing the injustice referred to.

It is probable that if all the earnings of a corporation were distributed as fast as they were earned to the individuals comprising the corporation then an income tax upon all individuals having a net income would bring about an equitable distribution of the tax burden and without any serious disturbance to the business conducted by the corporation. It is because such bodies do not always see fit

to distribute the earnings made that there has grown up a necessity of attempting to tax the stockholder by placing the tax upon the corporation and then permitting the stockholders to deduct from their individual incomes the income already taxed to the corporation. This method is correct in theory but has not been duly carried out in all cases. The theory has been partially worked out in the taxation of corporations by the federal government where it has been found necessary to impose a part of the income tax upon the corporation upon the theory that the earnings might not be distributed to the stockholders and the payment of the tax upon such earnings prolonged for an indefinite period unless the corporation were taxed for the year the earnings were made.

In order to avoid double taxation it is provided under the federal income tax law that for the purpose of the normal tax, individuals shall be permitted to deduct from their total net income the amount received as earnings or dividends from corporations which have been subjected to the tax upon their earnings. This is a correct theory, but Congress refused to carry it out in all cases for it did not permit under the Act of October 3, 1911, nor under the Act of September 8, 1916, corporations to deduct from their net earnings dividends received from other corporations which had already paid the tax, although such deduction was permitted under the original Act of August 5, 1909, and is also permitted so far as the additional war income tax is concerned under the Act of October 3, 1917. The Act of October 3, 1917, imposes two income taxes upon the net income of corporations, that is, it extends and perpetuates the Income Tax Act of September 8, 1916, which imposes a normal income tax of 2 per cent and then imposes an additional normal income tax of 4 per cent upon corporations.

Under the Act of September 8, 1916, as amended by the Act of October 3, 1917, corporations are not permitted to deduct dividends received from other corporations that have been subject to the same tax, while they are permitted to deduct the income from such corporations under the 4 per cent provision of the Act of October 3, 1917. The obvious purpose of permitting corporations to deduct the dividends received from other corporations under the 4 per cent provision of the Act of October 3, 1917, is to prevent double taxation of the same earnings, and is an acknowledgment upon the part of Congress that such earnings should not be doubly taxed. If this

be true of such earnings under the 4 per cent provision of the Act of October 3, 1917, it is equally true in regard to the 2 per cent provision under the Act of September 8, 1916, as amended by the Act of October 3, 1917, and there should not exist this inconsistency in the Act of Congress and this discrimination against corporations as compared with the taxation of partnerships and individuals in competition with corporations. Individuals, whether they are doing business as partners or as individuals, are permitted to deduct all dividends received from corporations made subject to the tax, and the same privilege should have been accorded to corporations.

Right here it might be well to note another discrimination in the imposition of the income tax under the Act of October 3, 1917. By that act there is imposed upon corporations an additional tax of 4 per cent upon net income, whereas the additional rate upon individuals is only 2 per cent. Therefore those individuals whose property consists of corporate securities are discriminated against when compared with other individuals.

In the imposition of income taxes generally it has been believed to be equitable to increase the rate of tax by a progressive scale whenever the amount of net income exceeded a certain amount. This is evidently upon the theory that ability to pay increases to such an extent with the increase in the net income that a flat rate of tax upon all income does not reach a proper proportion of ability to pay in all cases. The tax at the progressive rate as distinguished from the tax at the flat rate is known as the additional or surtax.

The theory of the surtax has always been that it should not be imposed or applied except in cases where the total income exceeded a certain amount. Upon this theory it is at once seen that an additional or surtax cannot be imposed upon a corporation because a tax upon the corporation as we have seen is a tax upon the stockholders and if the additional or surtax is imposed upon the stockholders by a tax upon the corporation it must necessarily be imposed regardless of the total amount of net income received by any particular stockholder contrary to the fundamental theory of the additional or surtax. Therefore, in order to carry out this correct principle, when the income tax was originally imposed by Congress, no additional or surtax was imposed upon corporations but such taxes were imposed upon all individuals regardless of the source of the income, provided the total net income exceeded a certain

amount. There is probably no way by which a surtax or additional tax can be imposed upon the corporation without doing violence to the principle that the surtax shall not be imposed except in cases where the total net income of the individual exceeds a certain amount thereby placing him in the class with ability to pay the surtax.

The excess profits tax if it had been imposed upon corporations alone would have amounted to an additional or surtax upon the corporation and would have done violence to this principle. This fact was evidently recognized by Congress as well as by the British Parliament in the imposition of the excess profits tax, for in each case the tax was imposed not only upon the corporation but upon partnerships and individuals as well in the hope of making an equitable distribution of the burden among all individuals as a tax upon business regardless of the character of the owner of the business.

It is extremely difficult to get an equitable distribution of an excess profits tax owing to the different methods of transacting business. It is probable that this system of taxation would not constitute a part of any well regulated tax system in times of peace. It is because in times of war certain businesses are extremely prosperous that it is thought equitable to take by taxation a part of the profits resulting from the war and use them for the purpose of conducting the war. This was the theory of the European excess profits tax acts and was the theory of our war revenue bill in the form reported to the Senate by the Senate Finance Committee. As the bill was finally passed, however, it became not a tax upon war excess profits unless the pre-war profits happened to equal from 7 to 9 per cent of the invested capital for the taxable year, but a tax upon profits exceeding a certain arbitrary percentage of capital.

As to all corporations whose pre-war profits did not fall within the special class, the tax under our War Revenue Act is not a war profits tax but an excess profits tax without regard to pre-war earnings. Therefore our tax upon excess profits at a sliding scale rate of 20 per cent to 60 per cent is not at all comparable with the war excess profits tax of Great Britain at the flat rate of 80 per cent. It might very well happen in a number of cases that our tax at a progressive rate of 20 per cent to 60 per cent would be much more burdensome to business in this country than the English tax upon war profits only, at the flat rate of 80 per cent, because in England only

abnormal profits resulting from the war are taxed while under our war revenue bill it is quite possible that the tax in many cases is based upon normal profits which bear no relation to the war. In England it was ascertained that the three years immediately preceding the European War were prosperous years for English concerns. These concerns were guaranteed a continuation of this prosperity free from the war excess profits tax by being permitted to select the two most prosperous years of these three prosperous years as a pre-war basis and all profits over and above the average profits of these two most prosperous years were taxed at a high rate but with full knowledge to the investing public that the normal profits of prosperous years would be guaranteed free from such tax.

It is of course less disturbing to business if the government can secure its revenue by a tax upon abnormal profits guaranteeing to the investing public a normal profit free from tax, than it is to place such tax upon normal profits and in the absence of such guarantee. As stated at the outset the object of any taxation scheme should be to produce the maximum of revenue with the minimum of disturbance to the business taxed.

Our revenue act on the other hand does not guarantee any freedom from taxation of all pre-war earnings, because as we have seen in a number of cases, our excess profits tax may fall upon normal profits or profits which have not increased or which perhaps have decreased since the war began. Our revenue act is not based upon war profits but may more properly be said to be based upon ability to pay upon the part of the business taxed, Congress having assumed arbitrarily that any earnings over and above a certain arbitrary percentage of the invested capital represent ability to pay taxes, to the extent of the exigencies of the government. It is probable that if each business could be treated separately, it could be ascertained in the case of each particular business what would constitute a reasonable exemption for the particular business. It is probably equally true that if each business, regardless of its nature or hazards, is permitted the same rate of deduction based upon the capital invested the scheme will necessarily bring about inequalities, taxing some businesses upon earnings abnormal and some upon earnings that are only normal or possibly less than normal.

It would seem that if it be found advisable to impose an excess profits tax instead of a war excess profits tax, that is, a tax based

upon earnings in excess of a certain arbitrary amount instead of a tax upon earnings resulting from the war and in excess of normal earnings of the business in each case, then some reasonable attempt should be made to classify business in regard to the hazards of the business so as to determine what the deduction should be in regard to each class of business taxed. An arbitrary deduction of 9 per cent on the capital invested, for example, is probably insufficient to guarantee to certain classes of business a fair return upon the capital invested free from the tax while it is probably more than sufficient for such guarantee in the case of other classes of business.

In the imposition of the capital stock tax the United States Treasury Department has officially determined that a certain class of corporations geographically located in a certain way must earn a certain amount on the capital invested in order to make the stock worth par, while other classes of corporations, or the same class differently located geographically, must earn an altogether different amount to make the stock worth par. This fact established by the United States Treasury Department is a confirmation of my contention that you cannot set up an arbitrary allowance of percentage upon capital invested and apply it generally to all business without favoring certain classes of business as compared with other classes.

In closing I want again to say that the object of any tax legislation should be the maximum amount of revenue with the minimum of disturbance to the business taxed. A tax upon an individual, as such, apart from his business, who ultimately receives all business profits, can probably be borne with patriotism without disturbance to business enterprise, but a tax upon business whose credit depends not upon patriotism or anything emotional but upon sound business finance, if sufficient to interfere with such credit, may upset the whole financial and commercial structure of the country, and the result of such business disturbance is much worse in times of war than in times of peace and probably produces more suffering among the people as a class than any tax ever laid upon an individual as a personal tax.